BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
)
INSTITUTE OF MUSICAL EDUCATION, LTD. )

Appearances:

For Appellant: E. P. Clark & Co.

For Respondent: Albert A. Manship, Franchise Tax Commissioner

O P I N I O N

This is an appeal under Section 25 of the Bank and Corporation Franchise Tax Act (Stats. 1929, Section 13, as amended) from the action of the Commissioner in overruling Appellant's protest against a proposed assessment of additional taxes in the amount of $310.17 based on petitioner's return for the taxable year 1929. The assessment of the additional tax was proposed due to the fact that the Commissioner disallowed a portion of an amount paid out by the petitioner during the taxable year as salaries for services rendered.

The Appellant also states that it erroneously reported as income for 1929 an item of $8,270.69, alleged to have been collected on contracts which were valid and enforceable on January 1, 1928. The Appellant asks that its taxable income as reported for 1929 be reduced by the above amount.

The Appellant was organized in 1926 for the purpose of engaging in the business of musical education. It agreed under contract with its president and treasurer to pay each of these officers a salary of $7,500 per annum, or a total of $15,000 per annum. Due to a lack of funds there was less than $4,000 paid on these salaries in 1926, less than $87,000 paid in 1927, $16,236.98 paid in 1928 and $24,833.25 paid in 1929.

The Appellant kept its accounts on the cash receipts and disbursements method and claimed as a deduction from its income for the taxable year 1929 the full amount of $24,833.25 paid by it on account of salaries, although only $15,000 of said amount was for services rendered during the year 1929. The Commissioner allowed as a deduction $15,000 paid for services rendered during 1929, but dieallowed the excess over that amount,

Section 8a of the Bank and Corporation Franchise Tax Act provides that:

"All of the ordinary and necessary expenses paid

> or incurred during the taxable year in carrying on business, including a reasonable allowance for salaries or other compensation for personal services actually rendered * * *"

shall be allowed as a deduction in computing net income.

The Commissioner did not, nor do we consider it proper to question the reasonableness of the salaries agreed to be paid by the Appellant to its president and treasurer, namely, $7,500 per annum for each, or a total of $15,000 per annum for the two officers. Hence, the sole question for us to decide with respect to the deduction for salaries is whether a corporation reporting on the cash receipts and disbursements basis may deduct in one year amounts paid out during the year as salaries for services rendered in prior years for which liability had been incurred in prior years,

The Commissioner contends that amounts paid out for services rendered should be deducted only if the services were rendered during the year. We do not believe that this is the proper construction to be given to Section 8a above quoted.

In Ox Fibre Brush Co. v. Blair, 32 Fed. (2d) 42, in construing a provision in the Federal Income Tax Act of 1918 exactly the same as the provisions of Section 8a of our Act above quoted, it was said at page 46:

> "The statute does not limit its application to services rendered within the taxable year."

Furthermore, it is to be noted that Section 8a contemplate: that expenses, including salaries, should be allowed as a deduction if "paid or incurred" during the year. It is true that this does not mean that the taxpayer has the option of deducting expenses either in the year when incurred or in the year when paid. (United States v. Mitchell, 271 U.S. 9, and appeal of Henry Reubel 1 B.T.A. 676), but, the taxpayer may, nevertheless! adopt any system of accounting which clearly reflects its income (Section 12 of the Act).
Section 11c provides that:

> "'Paid or incurred' should be construed according to the method of accounting upon the basis of which the net income is computed hereunder."

Construing the term "paid or incurred" as it is used in Section 8a, together with the definition of the term as set forth in Section 11c, we think it follows that if a taxpayer reports on the cash receipts and disbursements method, he should be allowed to deduct, ordinarily, all amounts paid out for services rendered, whether rendered during the taxable year or not. (See appeal of Henry Reubel, 1 B.T.A. 676).

If it should be held that only amounts paid for services rendered <u>during</u> <u>the taxable</u> year are deductible, then it would follow that a taxpayer reporting on the cash receipts and disbursements method would not at any time be allowed to make a deduction for services rendered when such services were rendered in one year and paid for in another year. The deduction could not be taken in the year when services were rendered because no disbursements were made on that account in that year The deduction, likewise, could not be taken for the year when payment was made because the services were not rendered during that year. Hence, it would follow, as Appellant claims, that in effect, a corporation could not keep its accounts on a cash receipts and disbursements basis.

Although we are of the opinion that ordinarily a corporation keeping its accounts on a cash receipts and disbursements basis may deduct amounts paid during the year for services rendered whether such services were rendered during the year or in some prior year, we nevertheless are of the opinion that the amount paid by the Appellant during 1929 on account of overdue Salaries for services rendered during prior years, should not be deducted from the Appellant's income in 1929,

It is to be noticed that during the year 1928, Appellant paid, on account of salaries of its president and treasurer, the sum of $16,239.90. Thus it appears that the services of the above officers rendered during the year 1928 were paid for in full in 1928. Consequently, it follows that the excess paid in 1929 over the amount agreed to be paid for services rendered in 1929 must have been for services rendered during the years 1926 and 1927.

It is apparently not, nor has it been at any time, the intention of the Act that income received or losses sustained prior to January 1, 1928 be considered for computing the tax provided for in the Act.

'Prior to its amendment in 1931, Section 13 of the Act provided that:

> "On or before May 15, 1929, every bank or corporation with a fiscal year ended during the calendar year 1928 shall file a return covering such fiscal year, and its tax for the months of the year 1929, corresponding to the months of 1928, which fall within the fiscal year ended during 1928, shall be according to or measured by such proportionate part of the net income of that fiscal year as the number of months falling within the calendar year 1928 bears to the total number of months in the fiscal year ended during that calendar year"

From this it appears, that although under certain circumstances income received during 1928 was to be considered in computing the franchise tax, income received prior to January 1, 1928, was not to be considered.

> provisions of subsection (b) (1) to (5), inclusive, of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized."

Hence, in view of the above provisions, it seems clear that if loss had resulted to the transferor from the exchange under consideration it would not have been recognized for federal income tax purposes, and if gain had resulted, it would have been recognized only in an amount not in excess of the money received ($300).

The above quoted provisions of the Federal Revenue Act of 1928 are incorporated by reference into the State Act by Section 20 of said Act which provides:

> "Upon the sale or exchange of property the entire amount of the gain or loss, determined under the preceding section shall be recognized, with the exceptions provided for in section 112 of said "Revenue Act of 1928," which are hereby referred to and incorporated with the same force and effect as though fully set forth herein."

Under this section it would seem that, although gain or loss resulting from an exchange is generally to be recognized, it is not to be recognized if it would not be recognized under the provisions of Section 112 of the Federal Revenue Act of 1928, including, of course, the provisions above quoted.

It is to be noticed, however, that the transferor in the exchange under consideration, being a co-partnership, was not a corporation taxable under the Act. Consequently, it would seem that any gain or loss resulting to it from the exchange was entirely without the purview of the Act. But assuming that the transferor was a corporation taxable under the Act, and consequently, by virtue of Section 20, above quoted, any loss resulting to it from the exchange would not have been recognized and any gain resulting would have been recognized only to a very limited extent, we are unable to perceive how this fact has any bearing whatsoever on the point involved in the instant appeal --i.e. what should be the basis for ascertaining gain or loss to the transferee, the Appellant corporation, as the result of the subsequent disposition of the property received by it pursuant to the exchange in question. It is one thing to say that gain or loss resulting from the exchange of property shall not be recognized; it is quite a different matter to determine what shall be the basis for ascertaining the gain or loss resulting from the subsequent disposition of such property.

Congress was apparently well aware of this in enacting the Federal Revenue Act of 1928, for, although Congress provided in Section 112 that gain or loss resulting from. certain exchanges and transfers should not be recognized, Congress did not rest there. Rather, Congress proceeded to prescribe in considerable detail, in Section 113 of said Act, what should be the basis for ascertaining the gain or loss in the event of the subsequent disposition of the property received pursuant to such an exchange or transfer.

In fact, one of the provisions in Section 113, namely subdivision 8 of Section 113(a) exactly covers the situations presented by the instant appeal. This provision reads as follows:

> "If the property was acquired after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities) then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made."

In view of the above provision, it is quite clear that for federal income tax purposes the cost to Appellant of the trust interests acquired by it in exchange for its stock could not serve as a basis for determining either gain or loss resulting from the subsequent disposition thereof. Rather, the basis would be the same as the basis for the transferor, i.e. the cost to the transferor of the property, if it was acquired subsequent to March 1, 1913, increased in the amount of the gain recognized to the transferor as the result of the exchange.

But it is to be noted that the State Act does not contain any such provision as the above. Further, we are of the opinion that the above provision cannot be considered as being incorporated into the State Act so as to be controlling in the instant appeal.

It is true that Section 8(f) provides that from gross income there shall be allowed as a deduction:

> "Exhaustion, wear and tear and obsolescence of property to be allowed upon the basis provided in sections 113 and 114 of that certain act of the Congress of the United States known as the "Revenue Act of 1928," which is hereby referred to and incorporated with the same force and effect as though fully set forth herein, or upon the basis provided in section 19 hereof,"

It is arguable that by virtue of the above provision, Section 113 of the Federal Revenue Act, including subdivision 8 of subsection (a) above quoted, is incorporated into the State Act for all purposes. But we are of the opinion that by Section 8(f), reasonably construed, it was intended to incorporate Section 113 of the Federal Revenue Act only for the purpose of computing depreciation allowance (exhaustion, wear and tear, etc.) and not for the purpose of determining gain or loss resulting from the sale or other disposition of property.

The only provision of the Act we have been able to find which relates to the method of determining gain or loss from the disposition of property which has been received as the result of an exchange with respect to which gain or loss was not recognized is Section 21 which provides:

> "When property is exchanged for other property and no gain or loss is recognized under the provisions of the preceding section, the property received shall be treated as taking the place of the property exchanged therefor."

In view of the above provision, it would seem that property received as the result of an exchange of the kind mentioned in the above Section (i.e. one with respect to which no gain or loss is recognized under Section 20) is to be regarded as steppin into the tax shoes of the property surrendered. In other words, the property received will acquire the same basis as the property surrendered for the purpose of determining gain or loss from the subsequent disposition of the property, regardless of what might be the value of the property received or of the property surrendered at the time of the exchange. Thus, if "A", a corporation of the classes taxable under the Act purchases property on January 1, 1929 at a cost of $5,000, holds it until it increases in value to $10,000, and then exchanges it for property of equal value, and the gain is not recognized under Section 20 of the Act, the cost to "A" of the property surrendered, i.e. $5,000 will serve as a basis for determining gain or loss from the subsequent disposition of the property received.

Although the exchange under consideration was not one with respect to which gain or loss was recognized under Section 20, the preceding Section mentioned in Section 21, nevertheless we do not believe that Section 21 can be regarded as specifying the basis for determining gain or loss to the Appellant from the disposition of the property acquired by it as the result of the exchange, If the contrary were held, then the property acquired by the Appellant would have to be considered as having obtained the same basis for determining gain or loss as the stock surrendered by the Appellant. But stock prior to its being issued for the first time can scarcely be considered as having a basis. Such stock does not cost anything. Further, when stock is issued for the first time, neither gain nor loss results to the corporation issuing it although money and property of value may be obtained *in* exchange therefor. Consequently, to hold that the property acquired by the Appellant obtained the same basis as the stock of Appellant issued for such property would result in holding that it obtained no basis at all.

There may be good reasons for providing, as is provided in subdivision 8 of Section 113(a) of the Federal Revenue Act of 1928, that, when property is transferred to a corporation in exchange for the corporation's stock and immediately thereafter the transferor obtains control of the corporation, the basis of the property in the hands of the corporation shall not be the cost thereof to the corporation but shall be the same as it was in the hands of the transferor. But clearly, there does not seem to be any good reason for providing that the property should be regarded as having no value at all for the purpose of determining gain or loss to the corporation in the event of the subsequent disposition thereof. We do not believe the Legislature intended that any such result should follow from the provisions of Section 21, above quoted,

Consequently, in the absence of any such provisions in the Act as is contained in subdivision 8 of Section 113(a) of the Federal Revenue Act of 1928, we are inclined to hold that the basis for determining gain or loss resulting to the Appellant from the disposition of the trust interests acquired by it in exchange for its stock, should be the basis provided in Section 19 of the Act. As above noted, Section 19 provides that the basis for ascertaining the gain derived or loss sustained from the disposition of property on or after January 1, 1928 shall be the cost thereof. Hence, we must hold that the Commissioner erred in disallowing as a deduction from Appellant's gross income for the taxable year ended April 30, 1931, the sum of $14,210.33 representing a loss sustained by Appellant during said year computed on the basis of the cost to Appellant of the trust interest

Thus, there remains for our consideration? only the problem as to whether the Commissioner erred in including in Appellant's income for the taxable year ended April 30, 1931, the sum of $1,035.74 representing "Additional Income Trust, #3736".

Apparently, the above sum was received during the above year by the Appellant as the result of the final disposition of one of the trust interests acquired by Appellant pursuant to the exchange hereinbefore considered, Using as a basis the cost to Appellant of said trust interest for the purpose of ascertaining gain derived or loss sustained to Appellant from the disposition of said interest, apparently, insofar as we are able to ascertain, Appellant did not realize any gain from the disposition thereof. Hence, it would seem that the Commissioner erred in considering the sum of $1,035.74, or any part thereof received by Appellant during the taxable year ended April 30, 1931, as income of Appellant for said year. If a corporation acquired property at a certain cost and later disposes of it for cost, or for less than cost, the amount received on the disposition thereof clearly cannot be considered as income. Rather, it should be regarded simply as a return of capital.

## O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, that the action of the Franchise Tax Commissioner, in overruling the protest of R. C. Mason & Co., Ltd., a corporation, against a proposed assess ment of an additional tax in the amount of $457.33, based upon the net income of said corporation for the period ended April 30, 1931, be and the same is hereby sustained in part and reversed in part. Said action is sustained insofar as the Commissioner disallowed as a deduction the sum of $347.88 representing additional federal income taxes for the period ended April 30, 1929. Said action is reversed insofar as the Commissioner disallowed as a deduction the sum of $14,210.33 representing capital losses sustained during the period ended April 30, 1931, and insofar as the Commissioner included as income for said year the sum of $1,035.74 representing the amount received during said year from the disposition of a certain trust interest. The correct amount of the tax to be assessed to the R. C. Mason & Co., Ltd., is hereby determined as the amount produced by means of a computation which will include the allowance as a deduction of the above sum of $14,210.33, and which will exclude as income the sum of $1,035.74 in the calculation thereof. The Commission is hereby directed to proceed in conformity with this order and to send the said R. C. Mason & Co., Ltd. a notice of assessment.': revised in accordance therewith.

Done at Sacramento, California, this 6th day of June, 1932, by the State Board of Equalization.

R. E. Collins, Chairman
Jno. C. Corbett, Member
H. G. Cattell, Member
Fred E. Stewart, Member

ATTEST: Dixwell L. Pierce, Secretary